

3. Domestic Economic Conditions

The Australian economy expanded at a below-trend pace over the year to the September quarter, although recent indicators point to some improvement toward the end of 2013 (Graph 3.1; Table 3.1). After growing very strongly over recent years, mining investment appears to have fallen by around 10 per cent from its peak a year ago. At the same time, investment by non-mining firms remained weak in an environment of relatively subdued demand and profit growth. Ongoing fiscal restraint resulted in only a slight increase in public demand. Growth of household consumption has been below average, consistent with little growth in employment over the past year and a marked slowing in wages growth. The level of dwelling investment has increased moderately, and a significant upswing looks to be in prospect, consistent with the recent strength in the established housing market. The depreciation of the exchange rate since the middle

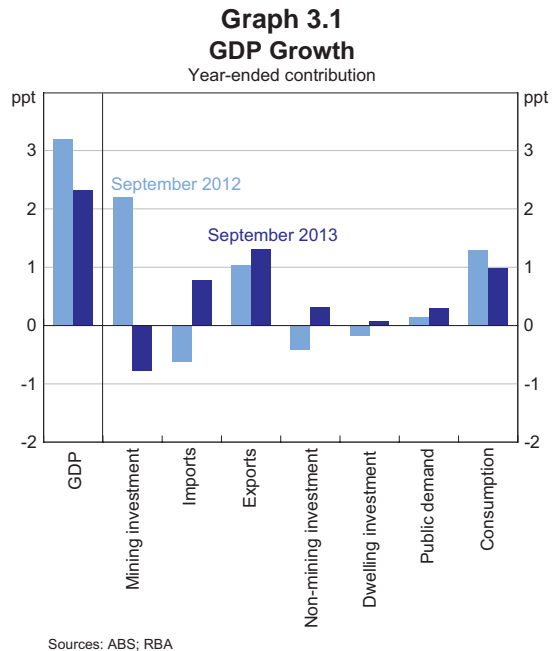


Table 3.1: Demand and Output Growth
Per cent

| | September quarter 2013 | Year to September quarter 2013 |
|--------------------------------------|------------------------|--------------------------------|
| GDP | 0.6 | 2.3 |
| Domestic final demand | 0.4 | 0.9 |
| – Private demand | 0.5 | 0.8 |
| – Public demand | 0.0 | 1.3 |
| Change in inventories ^(a) | -0.5 | -0.9 |
| Gross national expenditure | -0.1 | 0.1 |
| Exports | 0.3 | 6.1 |
| Imports | -3.3 | -3.7 |
| Nominal GDP | 0.6 | 3.6 |
| Real gross domestic income | -0.1 | 1.5 |

(a) Contribution to GDP growth
Source: ABS

of 2013 can be expected to start providing some support to domestic production. Exports have grown, although this has predominantly been among resource exports, reflecting mining projects continuing to move into the production phase.

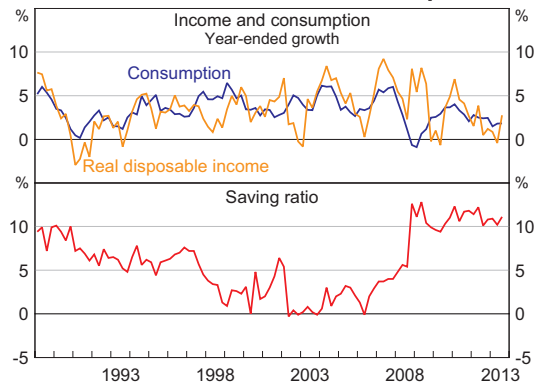
Economic indicators and liaison suggest that growth in the December quarter was moderate, although they generally point to some improvement in activity in recent months. Consumer spending on retail items picked up in the December quarter and surveys suggest that consumer sentiment has been a little above average levels, despite further weakness in the labour market. Housing turnover and prices have continued to increase and forward-looking indicators of dwelling investment have risen strongly. Trade data suggest that exports grew at a strong rate in the December quarter. Survey-based measures of current business conditions have improved over recent months, with some measures jumping sharply to above-average levels. However, surveyed business conditions had been below average for some time, and consistent with this, non-mining investment appears to have remained subdued. Firms' surveyed capital expenditure intentions indicate little growth in investment in 2013/14 as a whole. Liaison information continues to suggest that mining investment is in the process of a pronounced downswing.

Household Sector

Real household disposable income increased by 2¼ per cent over the year to the September quarter. Growth in labour income has been subdued, consistent with the weakness in the labour market. In contrast, a decline in interest payments has provided some support to measures of disposable income growth, as average mortgage rates have decreased in recent quarters.

Growth of household consumption was below average over the year to the September quarter, broadly in line with growth in income and notwithstanding a strong rise in household wealth. Consequently, the saving ratio has been little changed at a bit above 10 per cent (Graph 3.2). Over

Graph 3.2
Household Income and Consumption*

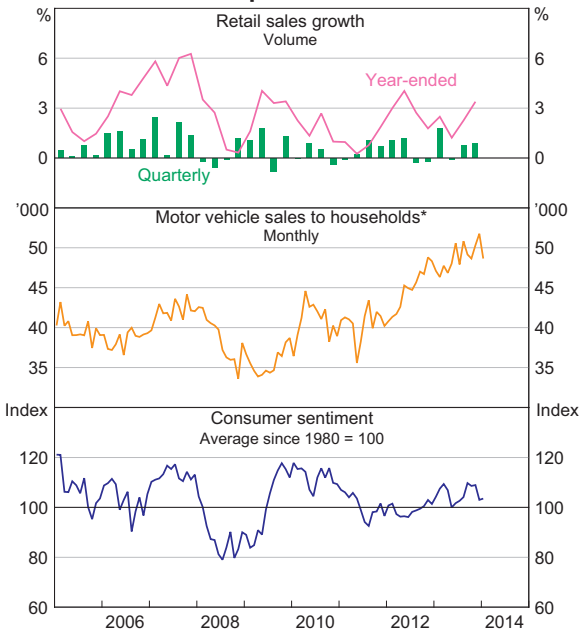


* Household sector includes unincorporated enterprises; disposable income is after tax and interest payments; income level smoothed with a two-quarter moving average between March quarter 2000 and March quarter 2002; saving ratio is net of depreciation
Sources: ABS; RBA

the past year, below-average consumption growth has largely reflected subdued growth in spending on discretionary items such as meals out and recreational activities. Spending on non-discretionary items such as food, health care and some financial services has grown at around the average pace of the past decade.

More recent data suggest that growth of household consumption increased a little in the December quarter. Retail sales volumes increased by 0.9 per cent in the quarter, with prices rising by 1.1 per cent (Graph 3.3). Sales increased particularly strongly at cafés, restaurants & takeaway stores and apparel retailers. Consistent with this, liaison with retailers suggested that the Christmas trading period overall was reasonably good, including for home improvement retailers as the buoyant housing market is reportedly supporting stronger sales. Motor vehicle sales continued to grow in the December quarter, although sales declined in January and growth over the past year has slowed from the rapid pace seen over 2012 when the high level of the exchange rate contributed to particularly attractive offers for purchases of motor vehicles. Survey measures of consumer sentiment are a little above average levels, despite having declined in recent months, and consumers' concerns about future conditions in the labour market remain somewhat elevated.

Graph 3.3
Consumption Indicators



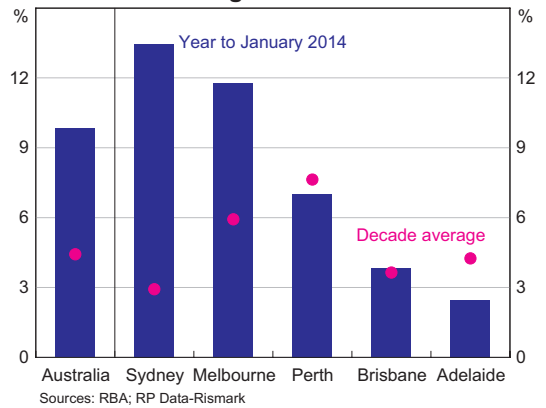
* Seasonally adjusted by the RBA
Sources: ABS; FCAI/VFACTS; Melbourne Institute and Westpac; RBA; Roy Morgan Research

Household wealth has continued to increase strongly in recent quarters and is estimated to be 10 per cent higher over the year to December 2013. This increase has been driven by higher equity and housing prices, as well as continued saving by households.

Nationwide housing prices increased by around 4 per cent over the December quarter and by a little under 10 per cent over the year to January (Graph 3.4). Housing price growth has broadened over recent months, with sizeable price increases in all state capitals in the December quarter. Sydney continues to be the strongest market, with prices rising by around 13 per cent over the past year. Nationwide, housing price inflation has been above the average of the past decade, a period during which prices grew marginally slower than household incomes. For more details on recent developments in housing prices, see 'Box B: The Housing Market'.

Conditions in the rental market remain relatively tight, although a bit less so than was the case some years ago. The nationwide rental vacancy rate declined a little in the September quarter, to around 2 per cent,

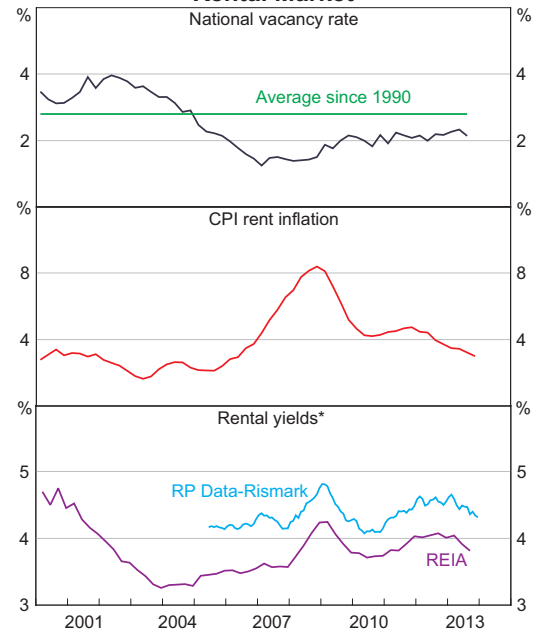
Graph 3.4
Housing Price Growth



Sources: RBA; RP Data-Rismark

which is below the long-run average but above the very low levels reached around 2007 (Graph 3.5). Rent inflation has slowed to around 3 per cent annually, the slowest pace since the mid 2000s, although it is still above the rate of CPI inflation. With growth in rents slowing and housing prices increasing strongly, rental yields have fallen in recent quarters to be around the average of the past decade.

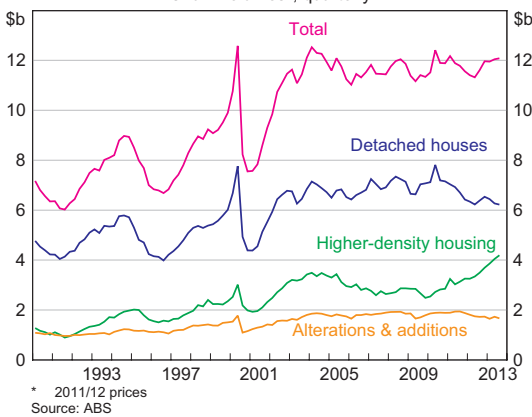
Graph 3.5
Rental Market



* REIA series uses an unmatched sample of rents and prices; RP Data-Rismark series uses a matched sample
Sources: ABS; RBA; REIA; RP Data-Rismark

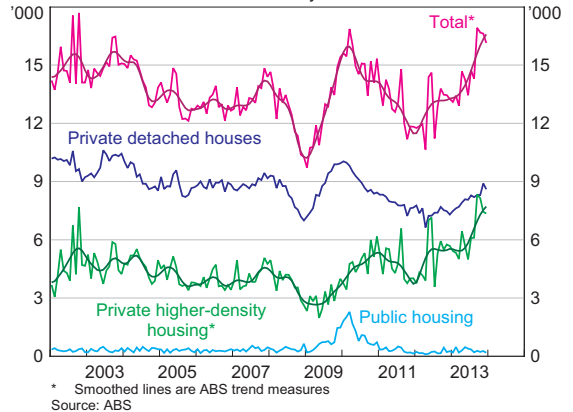
Dwelling investment was little changed in the September quarter, to be 1¼ per cent higher over the year. While work done on new dwellings continued to pick up, driven by the building of higher-density housing, there has been ongoing weakness in measured activity on large alterations & additions (Graph 3.6). The estimated activity on small alterations & additions, which is included in the national accounts, has also been weak.

Graph 3.6
Private Residential Building Work Done
Chain volumes*, quarterly



However, forward-looking indicators point to relatively strong growth of dwelling investment in coming quarters. The number of building approvals for new private dwellings rose by 7½ per cent in the December quarter, with higher-density and detached house approvals both rising strongly (Graph 3.7). Consistent with the steep increase in sales of new land in 2013, detached house approvals have continued to rise, buoyed by strong growth in New South Wales and a recent pick-up in Victoria, while approvals in Western Australia have moderated recently after an earlier upswing. Higher-density approvals increased very strongly over the second half of 2013, concentrated in the large eastern states. This was a significant increase, even by the standards of this volatile series. Liaison contacts have noted the increasing presence of overseas developers for high-rise developments in inner-city areas, particularly in Melbourne, Sydney and Brisbane. In part this may be a consequence of changes to

Graph 3.7
Residential Building Approvals
Monthly



foreign investment laws in 2009 that increased the share of new developments that foreign buyers were allowed to purchase. Builders also report an increase in confidence more generally, with more enquiries from prospective new home buyers.

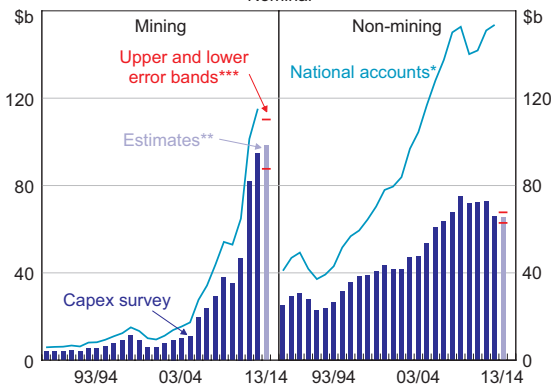
In aggregate, building approvals are expected to remain at a high level over the period ahead, underpinning strong growth in new dwelling construction. This reflects a continued recovery in the established housing market, low lending rates and government support to first home buyers that has increasingly been directed towards purchases of newly built rather than existing dwellings. Indeed, first home owner grants for new dwellings have already risen by around 60 per cent from their recent trough in 2011. Higher house prices and the associated increase in housing turnover are also expected to support a pick-up in renovation activity in the period ahead given that many renovations occur in preparation to sell a property or after one is purchased.

Business Sector

Business investment has declined from its peak in late 2012, but remains very high as a share of output both historically and in comparison with other advanced economies. The run-up in business investment in recent years reflected very strong growth in mining investment. Over the next few

years, however, mining investment is expected to fall, with Bank liaison suggesting that it is likely that the peak in the investment phase of the resources boom has passed. This is consistent with other information, such as the lack of new commitments to mining projects and the low level of expenditure on development and planning work. In contrast, the most recent ABS capital expenditure (Capex) survey of mining investment intentions, which tends to be a relatively imprecise guide to realised spending, points to further growth in 2013/14 (Graph 3.8). Nevertheless, estimates of spending by mining firms in 2013/14 derived from this survey have been revised lower over the past year.

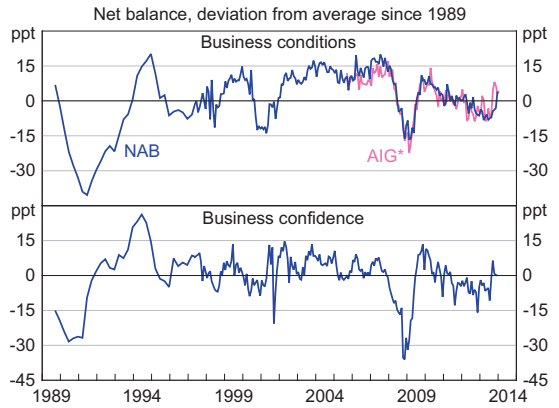
Graph 3.8
Measures of Private Business Investment
Nominal



* Adjusted for second-hand asset transfers between the private and other sectors, excluding cultivated and biological resources
 ** Estimates are firms' expected capital expenditure in 2013/14, adjusted for the past average difference between expected and realised spending
 *** Error bands are based on the root mean square error of each adjusted estimate compared with the final outcome for investment in each year
 Sources: ABS; RBA

In recent months, the Capex survey indicates that there has been a slight improvement in non-mining investment expectations (compared with earlier surveys for 2013/14), although firms continue to report that they have some spare capacity, which is likely to weigh on capital spending plans. Survey measures of business conditions jumped in the December quarter to be above their long-run averages. Business confidence is around its long-run average for most surveys (Graph 3.9).

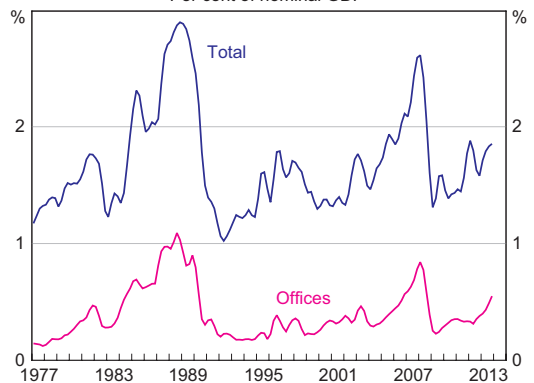
Graph 3.9
Business Sentiment
Net balance, deviation from average since 1989



* Weighted average of AIG's Performance of Construction, Performance of Services and Performance of Manufacturing indices, scaled to have the same mean and standard deviation as the NAB Business Conditions Index
 Sources: AIG; NAB; RBA

Confidence within the construction sector has improved in recent months, consistent with strong growth in residential approvals. The pick-up in approvals for non-residential buildings over the past year has been much less pronounced than for residential buildings, even though there is a large stock of work yet to be done on some large-scale healthcare projects (Graph 3.10). Approvals for office buildings have trended higher, even though the vacancy rate for national capital city CBD offices remains well above its decade average.

Graph 3.10
Private Non-residential Building Approvals*
Per cent of nominal GDP

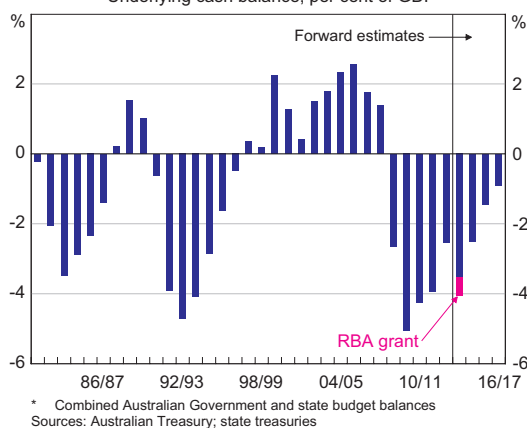


* 7-period Henderson trends
 Sources: ABS; RBA

Government Sector

The Australian Government's Mid-Year Economic and Fiscal Outlook, together with the recent state budget updates, suggest a larger consolidated state and federal budget deficit in 2013/14 and for the next few years. Abstracting from the planned \$8.8 billion grant by the Australian Government to the Reserve Bank, the majority of the widening in the deficit reflects a downward reassessment of prospects for growth of the economy, with future receipts revised lower and future payments revised higher (Graph 3.11). Nonetheless, the budget projections continue to imply a pronounced fiscal consolidation over coming years.

Graph 3.11
Consolidated Budget Balance*
Underlying cash balance, per cent of GDP



Farm Sector

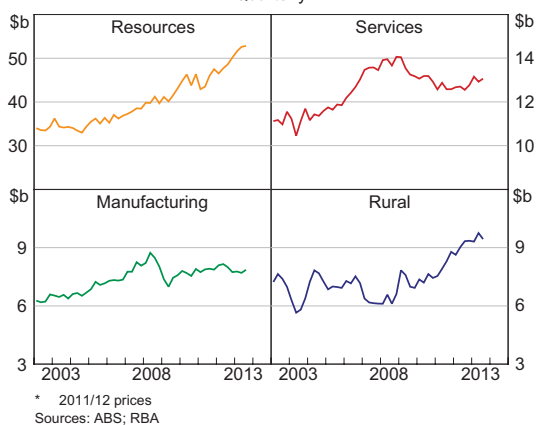
Around 60 per cent of Queensland is currently drought declared. The dry conditions there and in northern New South Wales have created unfavourable conditions for the planting of summer crops and led to an increase in cattle slaughtering (Graph 3.12). Despite this, farm production is forecast to increase 3 per cent in 2013/14 by the Australian Bureau of Agricultural and Resource Economics and Sciences. This improvement largely reflects an increase in production of the 2013 winter crop in other parts of the country.

Prices received by farmers overall are expected to increase in 2013/14, as the depreciation of the exchange rate and higher world prices for dairy products, wool and lamb, are expected to more than offset lower world prices for most grains.

External Sector

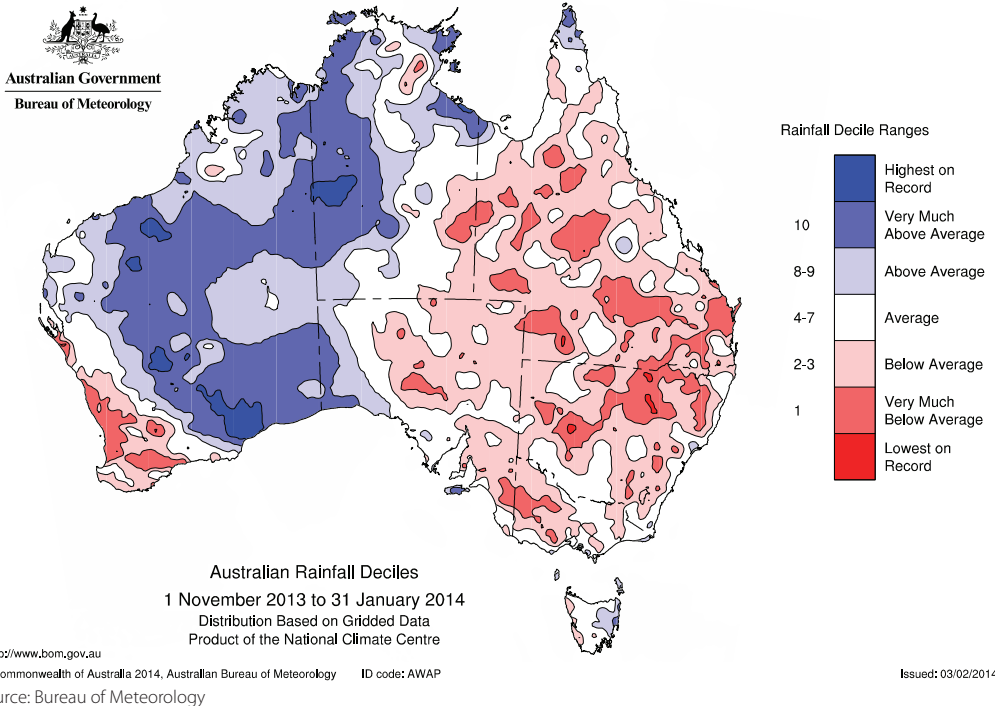
Exports rose modestly in the September quarter, as increases in resource, services and manufactured exports more than offset a decline in rural exports (Graph 3.13). The growth in resource exports was driven by stronger exports of iron ore, with coal exports falling slightly. Imports were 3.3 per cent lower in the quarter, with capital goods, intermediate goods and services imports all declining, while imports of consumption goods were unchanged.

Graph 3.13
Export Volumes*
Quarterly



More timely trade data suggest that iron ore volumes increased further in the December quarter, which accords with ongoing expansions to capacity. Coal exports appear to have rebounded in the quarter. Resource exports are expected to continue growing strongly over the next few years as further projects reach completion. Exports of services are estimated to have been subdued in the December quarter, although the recent depreciation in the exchange rate should, in time, provide some support for exports. Import volumes appear to have been unchanged over the December quarter.

Graph 3.12
Australian Rainfall
 1 November 2013 to 31 January 2014

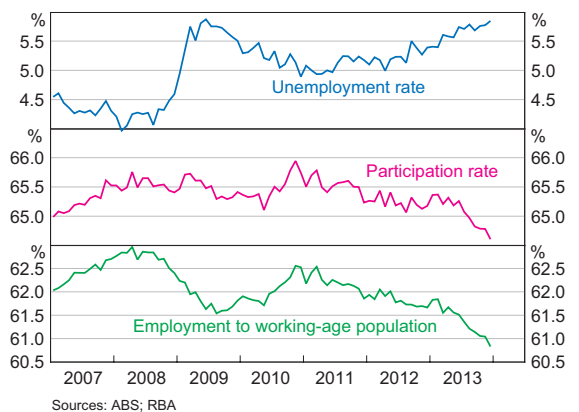


Labour Market

Labour market conditions have remained weak in recent months. The unemployment rate has continued to trend upwards, while the participation rate has declined noticeably since the middle of last year (Graph 3.14). There has been little growth in employment over the past year, and the ratio of employment to the working-age population declined to its lowest level since 2005. Total hours worked have also turned down in recent months, in contrast to the stronger growth observed up to mid 2013 (Graph 3.15). Measures of underemployment, which include employed workers wanting to work more hours, remain around their highest levels in the past decade.

The recent decline in the participation rate continues a trend seen since late 2010, and it is likely to reflect

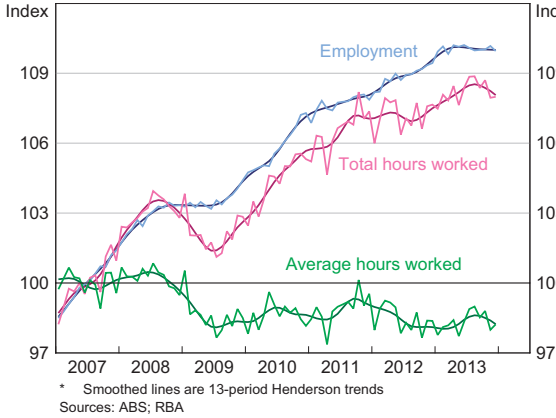
Graph 3.14
Labour Market



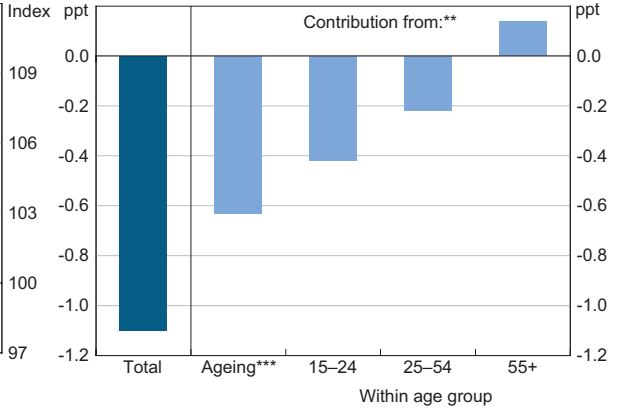
a mixture of structural and cyclical factors.¹ A little over half of the decline in the participation rate over this period can be attributed to the ageing

¹ See RBA (2013), 'Box C: The Labour Force Participation Rate', *Statement on Monetary Policy*, February, pp 40–42.

Graph 3.15
Employment and Hours Worked*
 2007 average = 100



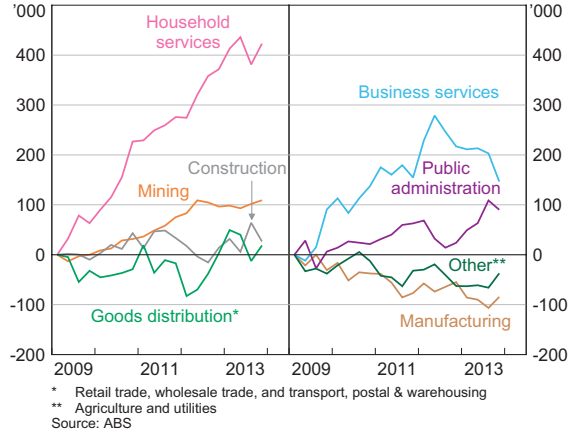
Graph 3.16
Change in Participation Rate*
 December quarter 2010 to December quarter 2013



of the population, since older persons tend to have a lower rate of labour force participation than younger working-age persons (Graph 3.16). The negative effect of ageing on the participation rate has picked up in recent years, as the oldest members of the relatively large baby boomer cohort have passed the traditional retirement age of 65 years. The remainder of the decline in the participation rate since late 2010 has reflected changes in participation rates within age groups. In particular, the rise in the participation rate of those aged 55 years and over has tapered off, in contrast to its relatively strong trend increase over the preceding decade. Also, the participation rate of 15 to 24 year olds and males aged 25 to 54 years has declined. Historically, a weak labour market has often been associated with a decline in participation rates within age groups, as discouraged jobseekers drop out of the labour force rather than continue to look for work, and so the decline in participation rates within age groups may reflect the weak state of the labour market. However, structural factors associated with policy changes or preference shifts may have also played a role.

The recent softness in aggregate employment outcomes has largely reflected declines in employment in the business services sector, where employment is now substantially below its 2012 peak (Graph 3.17). Employment declines in the sector have

Graph 3.17
Employment by Industry
 Cumulative change since February 2009



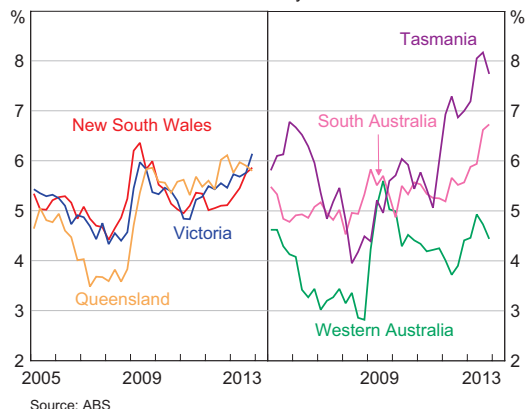
been largely attributable to the professional, scientific & technical and media & telecommunications industries, with Bank liaison indicating that business services firms that are exposed to the mining sector have been particularly affected. In contrast, overall employment in financial services has remained relatively stable since mid 2011. Mining employment has also been little changed over the past year and a half after earlier strong growth. These developments are consistent with the transition toward the less labour-intensive production phase of the resources

boom, as well as a continued focus by mining-related businesses on containing costs. Over recent years there has been a pronounced increase in household services sector employment (which includes the health, education and hospitality industries), driven mainly by the health industry. More recently, growth in household services employment looks to have slowed. Construction employment appears to have trended a little higher over the past year or so, consistent with the pick-up in activity in the housing market.

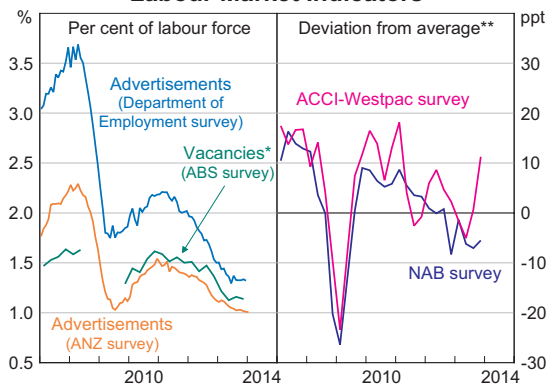
Labour market conditions have remained weak in most states. After relatively strong growth over the first half of 2013, employment has declined in New South Wales and Victoria over the past six months, while participation rates in both states have also fallen. Labour market conditions have also remained subdued in South Australia and Tasmania. In contrast, employment has continued to rise in Queensland and Western Australia over recent months, while the unemployment rates in these states have declined modestly (Graph 3.18).

Most forward-looking indicators of labour demand have shown tentative signs of stabilising in recent months, following earlier declines to relatively low levels (Graph 3.19). Measures of job advertisements and job vacancies were little changed over the second half of 2013. Reports from the Bank's liaison suggest that businesses' employment intentions have improved over recent months but remain weak compared with their history.

Graph 3.18
Unemployment Rates by State
Quarterly



Graph 3.19
Labour Market Indicators



* This survey was suspended between May 2008 and November 2009
 ** Net balance of surveyed employment intentions for the following quarter; deviation from average since 1989
 Sources: ABS; ACCI; ANZ; Department of Employment; NAB; RBA; Westpac